DEPARTMENT OF THE TREASURY
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ASSISTANT SECRETARY

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MEMORANDUM FOR: THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Marc E. Leland
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Subject: U.S. Policy On MDB Participation in Debt Rescheduling

Issue

Given the growth of multilateral development bank (MDB) debt exposure, situations could arise where debt service owed to the MDBs by a country seeking debt relief from its external creditors represents a significant portion of the total debt service falling due. For this reason, the CCEA Working Group on LDC Financial Problems examined the question:

Should the United States seek to reverse the traditional practice of excluding the MDBs from both official and private multilateral debt rescheduling operations?

Background

Principal and interest payments by 98 countries to multilateral organizations (including the MDBs) increased from $1.55 billion in 1975 to $4.42 billion in 1980 and, based on debt owed as of the 1980, will reach $8.8 billion in 1985. (Over two-thirds of the 1980 total is attributable to the World Bank.) Despite this increase, debt service to multilateral organizations as a percentage of total debt service on public or publicly guaranteed debt declined from 10.4 percent in 1975 to 8.2 percent in 1980. But, for a large number of countries the multilateral component is more important than aggregate data would suggest. This is the case particularly in low income countries -- although in many of these the level of multilateral exposure is still relatively small. There are also high concentrations in Central America.

With one exception, debts owed to international organizations, including the MDBs, have been exempted from participation in multilateral debt renegotiations. A firm MDB policy on arrearages has also minimized loan repayment problems under

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the threat to delay both loan disbursements and consideration of new loans if there are serious payment delinquencies. The fact that MDBs have been, in effect, treated as "preferred" creditors has not been controversial among creditor governments, in part because the financing arrangements supporting MDB operations are already based on an equitable cost-sharing basis and the exclusion of the MDBs from participation in debt operations has not been perceived as conveying any particular advantage among the major creditor countries. Furthermore, MDB loans have had longer maturities and lower interest rates than bilateral loans. The non-participation of the MDBs has also been considered to be in the mutual interest of creditors and debtors since it: (1) facilitated MDB efforts to maintain programmed lending operations in the affected debtor country --- concurrent with debtor country efforts to implement improved policies; (2) avoided damaging the creditworthiness of the MDBs in private capital markets; and (3) made it easier for MDB donor governments to secure necessary public and legislative support for MDB contributions and subscriptions.

Discussion

Arguments which have been raised for reversing U.S. policy and favoring the inclusion of the MDBs in multilateral debt renegotiations are that such inclusion would:

(a) be a logical extension of the "non-discrimination" and "comparable treatment" concepts which we apply to other creditor governments and private banks, respectively;

(b) avoid a situation in which creditor governments were in effect "bailing out" the MDBs, and

(c) instill more market discipline into MDB operations by encouraging more selectivity into the country allocation of lending.

-- The pattern of MDB loan approvals in 1971-81 to four recent recipients of multilateral debt relief shows mixed results on the question of whether there was any precipitous increase in MDB lending in the years prior to debt renegotiation.

The principal arguments for maintaining U.S. policy and continuing to exclude the MDBs from multilateral debt renegotiations are that exclusion:

(a) does not convey any particular disadvantage among creditors, who are also the major MDB shareholders;

-- other creditors have not expressed any significant dissatisfaction with current practice and a U.S. initiative to revise it would likely be highly contentious.

(b) avoids an adverse impact on MDB creditworthiness among bondholders, although admittedly it is debatable to what extent MDB participation in debt renegotiation would affect MDB ability to borrow in capital markets.

-- The World Bank Treasurer considers the Bank's excellent repayment record and the fact that it does not participate in multilateral debt reschedulings to be one of the two or three most important factors in marketing World Bank securities. Recent Treasury contacts with MDB underwriters in New York confirmed this fact; with one underwriter going so far as to say that World Bank participation in a multilateral debt renegotiation would immediately reduce its triple-A rating to a single-A rating, with consequent negative implications on the Bank's access to and cost of market financing.

(c) avoids the serious risk that MDB rescheduling would increase Congressional criticism of the Administration's decision not to seek appropriations for U.S. callable capital subscriptions to the MDBs;

-- the fact that MDBs have a good repayment record is perceived by MDB supporters on the Hill as a solid indicator of the banks' overall attractiveness as institutions to "put U.S. money."

(d) recognizes that MDB finance plays a somewhat different development role with a longer term economic perspective than either private sector finance or that portion of bilateral finance geared to export promotion; and

(e) reflects the case that can be made that the continuation of planned lending by the MDBs during a debt crisis situation already constitutes an important component of the multilateral effort to facilitate the debtor's recovery.

-- Net transfers from multilateral organizations generally do not appear to have been adversely affected to any major extent by debt crisis situations and have tended to remain high -- and in some recent cases, actually recorded significant increases. Since debt renegotiations are conditioned on the debtor country's commitment to an IMF program, these MDB net transfers should be taking place in an economic environment improved from that which occasioned the debt crises.

This pattern of MDB net transfers contrasts markedly with that of private creditors (suppliers credits/ financial markets) where declines or negative net transfers frequently were recorded during a debt crisis. While this is not surprising given the

nature of and the commercial criteria underlying the private debt, it does illustrate the disproportionate burden that would be placed on the MDBs vis-a-vis private creditors if the MDBs were also required to participate more directly in debt renegotiations at the same time they were maintaining normal MDB lending and loan implementation in a debt crisis situation.

MDB Co-Financing Arrangements

We have also examined the implications of MDB exclusion from rescheduling for MDB co-financing arrangements with commercial banks and other private lenders.

The objectives of U.S. emphasis on co-financing are threefold:

a. To maximize the impact of the technical assistance, project skills and market-oriented policy advice of the MDBs.

b. To reduce the MDBs' demands on the Federal budget and U.S. capital markets.

c. To facilitate LDC access to international capital markets.

To the extent that increased MDB private sector co-financing is consistent with these objectives, we welcome and encourage such activity. On the other hand, we would object to co-financing programs that become competitive with private sector financial institutions, or that encourage the MDBs to participate in low risk, high financial rate of return projects where their presence is not needed.

There has been significant growth over the past several years in both total MDB co-financing and the private co-financing component. Private sector participation in co-financed World Bank operations totaled $1.8 billion in both FY 80 and FY 81, and in FY 82 the level rose to over $3.2 billion. (The IDB has recorded a cumulative total of $532 million in private co-financing; the cumulative total in the ADB is $125 million.) The benefits to commercial banks of participating through co-financing with the MDBs include: MDB familiarity with LDC conditions and procedures, controlled exposure, low cost access to MDB project expertise, and the use of the MDBs as project appraiser and loan administrator.

Although private co-financing has increased, it still constitutes a relatively small component of the operations of both the MDBs and the commercial banks. In FY 82, only 16 of the World Bank's 150 operations involved commercial co-financing, and commercial co-financed loans represented only about 1.5 percent of outstanding commercial bank loans to IBRD borrowing member countries as of 12/31/81.

Given current commercial bank concern about lending to developing countries, the MDBs recognize that co-financing will have to be made more attractive if the expansion of private co-financing is to continue. In this context, there have been suggestions that the "cross-default" clause be made mandatory, also that new co-financing instruments and techniques be devised.

The World Bank has now specifically proposed an experimental "A/B" loan package in which a portion of the loan ("B loan") is designed to commercial specifications (variable rates) with both World Bank and commercial bank participation. This substantially increases the risk that the Bank will be under pressure to participate in both loan accelerations and reschedulings. Indications are that the Bank will strenuously reject these pressures, but it admits that it will be breaking new ground and that it cannot be foreseen how the parties involved might view a "B loan" in the actual circumstances of a debt rescheduling.

Under the "cross-default" provisions currently included in World Bank co-financing arrangements, the Bank, at its option, may decide to accelerate the repayment on the corresponding Bank loan outstanding if the co-lenders have taken legal action to accelerate their loan. The option is, however, entirely at the Bank's discretion and, has not been exercised to date. To our knowledge, there have not been any instances where the private sector component of an MDB co-financed loan has been rescheduled.

The United States would have serious problems if World Bank efforts to increase the attractiveness of co-financing arrangements sought to transfer the Bank's preferred creditor status (in rescheduling operations) to the private component of co-financed loans. However, any new co-financing procedures are far more likely to make a component of MDB lending liable to rescheduling than they are to attempt to exempt the corresponding component of commercial bank lending.

World Bank consideration of procedures which would make the Bank portion of co-financed loans liable to rescheduling would have to weigh seriously the impact of such a move on the Bank's overall credit standing in private markets. At the present time, the Bank appears opposed to the idea of making the cross default clause mandatory or to instituting what in effect would be "cross-rescheduling" provisions. Even if the Bank were to agree to specific transactions where it would more effectively "share the risks of lending" with its commercial co-financing partners, in A/B loans or other schemes, it would undoubtedly ensure that the remainder of its loan portfolio would remain exempt from rescheduling.

In summary, current co-financing instruments and techniques in no way conflict with U.S. debt rescheduling policy. However, new Bank proposals will be monitored closely as they evolve with a view to identifying situations where possible refinements or clarifications in U.S. debt rescheduling policy may be necessary or where the USG would want to oppose such proposals.

Recommendation

The Working Group concludes that no U.S. policy initiative is needed at this time on the issue of MDB debt rescheduling and supports the general practice of excluding the MDBs from multilateral debt reschedulings. At the same time, the Working Group recognizes that individual country situations could arise where the United States would be justified -- after a "case by case" analysis of MDB operations in a given country -- in encouraging individual debtor countries to seek relief in some form from the MDBs. In addition, MDB proposals on co-financing need to be followed closely as they evolve.

The Working Group recommends that the Cabinet Council endorse this position.